Feature

KEY POINTS

- Real estate assets are evolving away from traditional models.
- New business models require a different and more flexible approach to financing.
- "Hybrid" structures are emerging which combine key features of both "classic" real estate finance and leveraged loans.

Authors Jeffrey Rubinoff and Victoria Landsbert

Changing face of the real estate market

The market in real estate is in a state of evolution, with the rapid growth of quasi operational assets such as data centres and logistics centres, as well as the emergent, amenity heavy, private rented sector. We are also witnessing occupation of more conventional assets, such as offices, on more flexible terms. The varying nature of those business models means that a bespoke approach to underwriting a loan on those assets is often required. New structures are emerging which are a hybrid between "classic" real estate finance and leveraged loans.

EVOLUTION OF THE REAL ESTATE MARKET

Technology has affected a number of industries in recent years. However, it is only very recently that it is having a marked impact on the real estate sector (and, by extension, the financing of real estate).

The ever-increasing need for data centres and logistics centres are the most obvious tip of the technological iceberg, but are only part of the story. Demand for real estate is increasingly moving to a shorter-term, more flexible and adaptive model in other areas. Mixed-use developments are on the rise. In the residential space, the WeLive model provides accommodation with communal mailrooms and laundry rooms that double as bars and event spaces, as well as communal kitchens, roof decks and hot tubs. The turnover of tenants is far quicker than the industry is used to, with the flexibility to stay for just a few nights (the Airbnb model), or a much longer period.

Equally, the lines between residential and commercial space are becoming more blurred. The exponential growth of wireless connectivity continues to result in an increase in flexible working, and serviced office providers; this is now also feeding into developments combining living and working sectors. One example is the Barratt London and SEGRO collaboration on the former Nestlé factory at Hayes in West London, which envisages a two-fold development of the site; urban logistics warehouses and modern industrial space on one hand, and homes and communal spaces on the other.

In all cases, the demand is for more flexible spaces, both in terms of the need to accommodate mixed use, and more versatile (often shorter) tenancies which typically results in less predictable income flows. All parties investing in, or funding the acquisition of, real estate, will need to adapt to this new model.

IMPACT ON MARKET PARTICIPANTS

The systemic change in the real estate market gives rise to some key issues for borrowers, in optimising the debt component of the capital structures used to finance such businesses. For lenders, the challenge is ensuring adequate protection when advancing funds into a non-traditional business model. The change also impacts on sponsors, who need to consider differing approaches to fund their acquisition of real estate assets.

We have set out below some of the more significant issues that we have seen arising in recent deals, which all parties should be considering at an early stage, to ensure that the acquisition and financing of these non-traditional assets can proceed quickly and efficiently.

KEY ISSUES – AND SOME POTENTIAL SOLUTIONS

Rental income

As explained above, one of the main changes arising from the current market trends is the requirement for occupational flexibility. The knock-on effect of that flexibility is, of course, the lack of reliable long term rental income.

The absence of a long term contracted income flow has a consequential impact on the underwriting value that can be attributed to these assets. In order to ascribe value, lenders will need to look to the track record of a business and consider covenants based on its historic EBITDA; an approach which is more common in hotel deals. Additionally, lenders will need to consider whether there is any value outside of the contracts the business currently has with its tenants/users. For instance, a lender may need to take into account whether it can have some degree of confidence that alternate tenants could be easily found (for example, based on the asset's location) or whether there are viable, alternative uses for the space.

The other comfort that a lender can seek is a sponsor-level guarantee. Whilst these guarantees are fairly unusual in traditional European real estate financings, such a guarantee may be a condition to financing a more flexible operational business, without the certain and predictable rental income generation that would be expected in a more conventional financing structure. In some cases, such a guarantee could act as a substitute for proven track record, and fall away after a period of proven operations. In other cases, such a guarantee may be limited to a "bad-boy" guarantee or a "quarterly debt service" guarantee, depending on the negotiating strength of the sponsor.

Owner and operator

One of the other key themes to emerge is the rise in the range of real estate assets which require active management and are owned and managed by the same entity. Historically, owned assets were managed by an independent third party operator, giving the lender comfort that a reputable, qualified and economically stable external party was managing the asset which the lender was financing. However, the growth of logistics businesses, serviced office providers and similar market participants results in a more complex business

Biog box
Jeffrey Rubinoff is a partner in White & Case's London Banking practice. Jeffrey has represented both sides of the deal table on domestic and pan-European real estate finance and NPL transactions. He works with a wide range of clients from private equity houses, property investors and listed property companies to banks, sovereign wealth funds, mezzanine debt funds, noteholder groups and special servicers. Email: jeffrey.rubinoff@whitecase.com

model. As such, the health of the assets is increasingly dependent on the quality of the operator.

Where the identity of the operator is considered critical, lenders may wish to deal with this issue by incorporating key man provisions or adapting the change of control provisions in their finance documents. In more conventional real estate financings, change of control provisions focus on the identity of the sponsor. In some parts of the market, sponsors are seeking to agree deals on the basis that a change of ownership will not trigger a mandatory prepayment as long as the incoming sponsor is deemed to be acceptable. Where the quality of the operator can have a material impact on the economics of a deal, change of control provisions may instead state that a change of ownership is permitted provided that the operator remains the same. Additionally, key man provisions requiring that particular individuals remain involved in the operation and management of the business are likely to become a feature of financings of these sorts of assets.

Additionally, lender approval of the operator's business plan (and a requirement for that plan to be updated as the business develops and through the life of the loan) may be one way for a lender to get some additional comfort about the flexibility provided to the borrower as part of the financing.

Flexibility

For assets where active management is crucial to performance, such as flexible workplaces and mixed use residential spaces, owners and operators will require finance arrangements that allow flexibility in relation to management of the asset. Operators will be keen to ensure greater scope than is available in more traditional real estate financings. This is relevant both to the types of actions that can be taken in relation to the underlying property and how cashflows are managed. Key issues for borrowers will include ensuring their ability to undertake a wide range of leasing activities or development works, to keep up with client demand and remain attractive in their markets. Borrowers will also need to focus on their ability to utilise a sufficient amount of their cash flows to meet the costs of such activities.

These types of businesses will therefore have a need for working capital expenditure in a way that is not required in relation to traditional real estate assets. Lenders will need to be cognisant of these working capital requirements, and the associated costs. They should therefore consider having provisions regarding the use of cashflow by an owner or operator, and the determination of excess cashflow amounts, which are less restrictive than would be expected in more traditional real estate financings. The extent of borrower control over bank accounts and the use of funds from those accounts (and the sufficiency of such funds to meet expected capital investment requirements) is another reflection of the flexibility afforded to borrowers in a more "operational" model.

Recourse

Another consideration for lenders will be whether or not loans advanced in relation to these quasi operational assets will be made on a non-recourse basis. Conventionally, real estate loans were advanced on a non-recourse basis because a lender is able to take a view on the value of the underlying real estate, as well as its ability to generate cash flows. However, loans made in relation to alternative assets such as data centres are often advanced on the basis of the credit of a corporate group and its business as a whole, rather than in relation to a single real estate asset. This approach is often taken because it enables lenders to mitigate their risks by lending against the wider performance and assets of a business and consequently, having claims against a greater pool of assets.

Access to funding

Securing debt facilities for the acquisition of more non-traditional real estate assets may prove challenging for private equity investors, because of a lack of lenders willing or able to fund against these newer asset classes. In particular, it may be difficult where there is insufficient data or performance history to allow more conservative lenders to establish a reliable valuation of the assets and underwrite these loans. However, as a result, there are also opportunities for alternative capital providers to finance these assets, as they will have more flexibility to consider structures and assets which high street banks will be constrained from funding and for which investment banks may not have the appetite.

"HYBRID" FINANCING STRUCTURES

We are seeing a growing prevalence of "hybrid" loans, which take many of the asset value preservation features from a real estate loan, and combine them with the protection – and flexibility – afforded by a leveraged finance model.

In conventional real estate finance transactions, preservation of the value of the underlying asset is typically monitored by way of LTV and forward looking, lease contract based, financial covenants together with regulation of the maintenance of the property and conduct of business activities. Conversely, leveraged finance transactions focus on profit generating business activity and rely on covenants that measure a business' earnings and cashflow, in order to provide adequate protection for lenders.

Market participants will need to carefully consider how their financing arrangements deal with issues such as appropriate methodology and thresholds for establishing financial covenants, what constitutes permitted distributions, the determination of excess cash flow and whether cash sweeps or cash traps will apply. Ultimately, these loans will need to strike a balance to give lenders the protection they require whilst allowing borrowers to access the money needed to finance acquisitions and ongoing working capital requirements, as well as the flexibility needed to operate their business model.

Our recent experience with "hybrid" loan agreements has seen a number of new trends emerging. Cashflow flexibility is crucial, with borrowers receiving far more control over accounts generally than would be the case in a more traditional real estate

Feature

Biog box
Victoria Landsbert is a partner in White & Case's London Real Estate practice, combining significant experience in both commercial real estate finance and commercial real estate transactions. Victoria has worked on both "loan on asset" and "loan on loan" real estate financings, with a particular emphasis in the non-performing and re-performing loan sector. She acts for banks and private equity funds on both the lender and sponsor side.
Email: vlandsbert@whitecase.com

financing. Lender control over disposal of assets is also reduced, with borrowers more frequently having the ability to reinvest the proceeds rather than applying such proceeds in repayment of their loans.
A more flexible approach to taking security (both in terms of timing and the proportion of assets to be secured) is also a trend that we have seen, again more typical of a leveraged finance transaction.

We are also seeing borrowers achieving greater flexibility in terms of what constitutes permitted activities. Provided that excess cash (after debt service) is used, lender consent may not be required for asset acquisition and capital expenditure, as long as certain financial metrics are satisfied. Occupational letting activity might also be permitted, provided leases are granted on arms' length terms and subject to the effect on rental income.

COLLATERAL PACKAGES

Another key point to be considered when financing these less traditional real estate models, is the collateral package that can be obtained to secure the lending. In a traditional UK financing, security will usually take the form of a comprehensive debenture containing fixed and floating charges over all (or substantially all – in order for the charge to be a qualifying floating charge for the purposes of the Insolvency Act 1986) of a company's assets, as well as the specific mortgage security. However, in other jurisdictions (notably many of the continental European jurisdictions), there is no such security instrument. Careful thought will therefore need to be given at the outset of a transaction, to ensure that the lender has the benefit of security over all pertinent contractual rights and other assets; not just the real estate. The assets will obviously vary depending on the business being operated by the borrower, but there may be real value in intellectual property rights (eg a brand name), website and other electronic assets, as well as "hard assets" such as IT equipment (eg when granting security in respect of a data centre). The value of these assets will be key to the lender assessing the value of the business against which it is proposing to advance funds, but also to the security package to be granted as part of the transaction.

Further, in line with the borrower's requirement for flexibility, and the lender's view on the underwriting risk, lenders may agree to take security over only a proportion (rather than all) of the assets, or to take security only after a specified time period, as is more typical in leveraged finance transactions.

ENFORCEMENT

The final piece in the puzzle is, inevitably: what happens if it all goes wrong? Are there any additional enforcement rights that a lender should contemplate at the outset of a transaction? As discussed above, the underwriting approach to a "hybrid" transaction looks at the performance of the business, and not just the value of the real estate assets.

As we explained previously, one of the key considerations for a lender is the identity of the operator, and its business plan.
If, however, the operator does not perform as expected, the lender needs to be able to take active steps. Step-in rights, as commonly seen on a project finance transaction, or the ability to replace the operator, may be required to enable the lender to exercise some enforcement and control over a non-traditional business model, in this ever-evolving market.

The complexity of the enforcement process generally will, of course, depend on the nature of the secured assets (and their respective value), other than the real estate. Particularly if the value is derived from less traditional assets (eg a website and online booking process, IP rights, electronic equipment etc), it may be that the best enforcement approach is to rely on the step-in rights and/or to appoint a quality replacement operator, rather than seeking to enforce in a more traditional manner. A lender's approach to enforcement may need to be as flexible as its approach to the original loan.

CONCLUSION

The real estate market has undergone substantial change over recent years, with new asset classes continuing to emerge.
The key word that encapsulates these new asset classes is flexibility; both in terms of flexibility being essential for the borrower to be able to operate its business, as well as the underwriting approach required in order to garner returns from investing in these evolving assets. The more developed market in purpose-built student accommodation shows that there remains appetite for investment in less traditional real estate models. As the evolution of the real estate market continues apace, we expect to see an ever-increasing number of these "hybrid" real estate finance loans in the future. ■

Further Reading:

- Enforcement of real estate loans: options and changing approaches (2017) 8 JIBFL 493.
- Forward funding: borrowers, developers and financiers (2017) 1 JIBFL 25.
- LexisNexis Loan Ranger blog: Examining the LMA's recent changes to real estate finance and intercreditor agreements.